

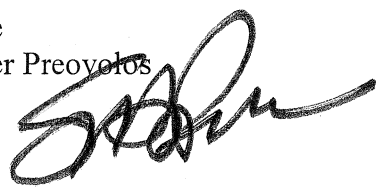


**City of San Diego  
COUNCIL PRESIDENT SCOTT PETERS  
DISTRICT ONE**

**M E M O R A N D U M**

**DATE:** June 13, 2006

**TO:** City Attorney Michael Aguirre  
SDCERS Board President Peter Preovolos

**FROM:** Council President Scott Peters 

**SUBJECT:** Use of SDCERS Surplus Undistributed Earnings ("Waterfall")

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In 1980, the City Council adopted Ordinance No. 15353 which started the City's practice of using surplus undistributed earnings (investment earnings received) from the San Diego City Employees Retirement System ("SDCERS") trust fund for payment of supplemental benefits specified in the San Diego Municipal Code ("SDMC") Section 24.1502. Subsequent legal settlements and retirement-related policy decisions by the City have further expanded the use of these investment earnings. The surplus undistributed earnings are allocated for "contingent benefits" in the priority order specified in the SDMC. The elements of this method have become known as the "Waterfall."

The City of San Diego Pension Reform Committee, Luce Forward LLP, Vinson & Elkins, the previous and the current SDCERS' independent actuary and Navigant Consulting have all suggested that the use of the surplus undistributed earnings may violate the principles and soundness of actuarial science. The Vinson & Elkins report stated that the surplus earnings concept ignores the long-term dynamics of actuarial projection unless it can be demonstrated that the actuarial projections are unrealistically conservative. SDCERS board members have expressed a strong desire to include the contingent liabilities in the Retirement System's total actuarial liabilities.

The City Charter and the SDMC govern the operation of SDCERS. The City Council must amend the appropriate municipal code provisions in order for SDCERS to discontinue the "Waterfall." The following Municipal Code provisions dictate the practice for the surplus undistributed earnings. I have included suggestions for possible action to remedy this situation. Since many of the provisions were the result of settlements in prior litigations, any action may require an approval between the City and the eligible retirees. In response to this memorandum, I respectfully request the City Attorney's analysis on the questions of eliminating any provisions that contain the use of surplus undistributed earnings. Also, if necessary, the City Attorney

should submit the appropriate items to be docketed at a Council meeting at the earliest possible date. In addition, I request that the SDCERS Board ask its actuary and tax counsel about the issue of including contingent liabilities of the 13<sup>th</sup> Check and Supplemental Cost of Living Adjustment ("COLA") with the total actuarial liability of the system and how that might affect the provision of those contractually agreed benefits.

**1. SDMC 24.1502 (a) (1): Credit the contribution accounts of the employers at a rate determined by the board.**

SDCERS Board and various studies have questioned the principle and soundness of the use of surplus undistributed earnings. In order to eliminate this practice, I respectfully request an opinion from the City Attorney and the SDCERS Board on the possibility of amending SDMC 24.0901, and authorizing the SDCERS board to credit contribution accounts of all plan sponsors, and the members of employee contribution accounts (maybe for the exception of the DROP account), annually in an amount determined by the board. If the City Attorney, SDCERS board and the City Council approve of such action, SDMC 24.0904 should be amended to include "contracting public agencies," along with the City.

**2. SDMC 24.1502 (a) (2): System's operating budget.**

Even with the elimination of the concept of the use of surplus undistributed earnings, the system can pay for its own budget with one of its reserve funds. It is my understanding that this is standard practice of the majority of public retirement systems in the country.

**3. SDMC 24.1502 (a) (3): Fund any "reserves" as recommended by actuary and counsel.**

Currently only the DROP contribution reserve is under this section. SDCERS has brought to my attention that DROP provisions allow the SDCERS board the authority to determine the rate at which to credit earnings to DROP participant accounts. Historically, the board has credited the accounts at the same rate as the Employee and Employer Contribution Reserve, which has been 8%. There are opinions from SDCERS that this has placed the retirement board in the position of changing compensation levels for active city employees enrolled in the DROP program. In exchange, this could affect the City's ability to recruit and retain experienced employees and takes away from surplus undistributed earnings when the system's earnings fail to meet the expected rate of return.

One of the possible recommendations from SDCERS was to change the municipal code to allow the City Council the sole authority to determine the interest rate credited to DROP accounts for future DROP participants through the Meet and Confer process with the City's employee unions and at the advice of SDCERS investment counsel and the City Auditor. I request that the City Attorney provide the Mayor and the City Council a legal analysis on changing credit earnings for current DROP participants. I also request SDCERS board members' input on the DROP crediting issue.

**4. SDMC 24.1502 (a) (4): Credit proportional share of the system's earnings to the United Port District and Airport Authority.**

After crediting interest to the contributions accounts of the plan sponsors, withholding sufficient sums to meet budgeted expense of the system and payment for legally required payments to eligible retirees, all remaining surplus undistributed earnings should be used for the sole purpose of paying down the underfunded liability (UAAL) of the system.

**5. SDMC 24.1502 (a) (5): Retiree Health Insurance.**

This reserve has been exhausted as of FY 2006 and the City has been directly paying the full cost of retiree health benefits on a pay-as-you-go basis. Under the municipal code, this benefit is still a liability of the retirement system. Appropriate actions need to be taken to remove this section from the SDMC and amend SDMC Section 24.1203 to make this benefit the sole responsibility of the City. In addition, the last sentence of SDMC Section 24.0801, which states that "the portion of the contribution that the City designates for the 401(h) Fund or the Health Trust, to be used for retiree health benefits under Division 12, is not a deficiency within the meaning of this section" should be deleted from this section to reflect the update of the City practice for payment of Retiree Health benefits.

**6. SDMC 24.1502 (a) (6): 13<sup>th</sup> Check to a closed group of retirees.**

The SDCERS' actuary recommends including the 13<sup>th</sup> Check in the total actuarial liabilities of the system. The total actuarial liability of the 13<sup>th</sup> check is estimated to at \$56.7 million. Since its existence, this benefit has been paid 85% of the time. SDCERS board has expressed its desire to include this payment in the City's contribution. In order for SDCERS to include this benefit into its total actuarial liabilities, Council action is needed to remove this provision from SDMC 24.1502 and be appropriately included in SDMC 24.404. Since this benefit resulted from a legal settlement between the City and retirees back in the 1980's, the recommended change may require approval of the City and eligible retirees. I request the SDCERS board ask its actuary and tax counsel about the issue of including contingent liabilities that are not accrued, as part of the total actuarial liability of the system.

**7. SDMC 24.1502 (a) (7): Corbett retiree liability to closed group of retirees.**

One of the provisions of the Corbett settlement was for a 7% increase in retirement benefits to retirees who retired on or before June 20, 2000. The settlement allowed for these payments contingent upon the system having sufficient undistributed earnings after the 13<sup>th</sup> Check is paid. If the system does not have sufficient undistributed earnings, the liability for that fiscal year is carried forward (without interest) to the next year until there are sufficient earnings. It is a desire of the SDCERS board and the SDCERS actuary that the Corbett benefit is part of the retirement system's total actuarial liability. In order for SDCERS to include this benefit into its total liabilities, Council action is needed to remove this provision from SDMC 24.1502 and be appropriately included in SDMC 24.404. The total actuarial liability of the Corbett settlement is estimated to be at \$58.9 million. Since this benefit resulted from a legal settlement between the

City and retirees back in the 2000, the recommended change may require approval of the City and eligible retirees.

**8. SDMC 24.1502 (a) (8): Credit the Supplemental COLA Reserve and the Employee Contribution Reserve.**

In 1998, supplemental COLA fund at \$35 million was established for members who retired on or before June 30, 1982. As of June 30, 2005, this reserve had approximately \$17.8 million. Interest to this reserve account is contingent on undistributed surplus earnings, but the liability is not carried forward. I request the City Attorney and SDCERS' tax counsel and actuary advise the Council on the best course of action for the provision of this benefit. I request the SDCERS board ask its actuary and tax counsel about the issue of including contingent liabilities that are not accrued, as part of the total actuarial liability of the system.

**9. SDMC 24.1502 (b): The remaining balance is credited to the Employer Contribution reserve for the sole purpose and exclusive purpose of reducing the UAAL.**

After crediting interest to the contribution accounts of the plan sponsors, withholding sufficient sums to meet budgeted expenses of the system and payment for legally required payments to eligible retirees, all remaining surplus undistributed earnings should be used for the sole purpose of paying down the underfunded liability (UAAL) of the system along with the possibility of removing all concept of the use of undistributed earnings.

Thank you very much for everyone's assistance.

SHP:wjs

CC: Honorable Mayor and City Councilmembers  
Ronne Froman, Chief Operating Officer  
Andrea Tevlin, Independent Budget Analyst  
Jay Goldstone, Chief Financial Officer  
John Torell, City Auditor  
SDCERS Boardmembers  
David Wescoe, SDCERS Retirement Administrator  
Scott Chadwick, Labor Relations Manager